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One Step Forward

The Deficit Reduction Package of 1990

Center on Budget and Policy Priorities

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Paul Leonard
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Center on Budget and Policy Priorities
Washington, D.C.

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I. Introduction: A Budget Package That Exceeds Expectations

On October 27, Congress ended months of bitter struggle over legislation to reduce the federal deficit and gave final approval to a major budget package. The process by which the legislation was produced was long, fractious, and often highly partisan. Yet the final product must be accorded high marks. It substantially reduces the deficit, modestly reorders priorities, asks the wealthy to shoulder a reasonable share of the burden, and contains a series of new initiatives to assist low income working families with children.

The final package does have some drawbacks, however. Principal among these are the relatively high levels of spending it provides for defense, along with a provision preventing any funds from being shifted from defense to domestic needs until fiscal year 1994.

A Major Improvement Over the Summit Agreement

The final budget package is a major improvement over the original budget summit agreement unveiled in late September. The summit agreement was regressive: it would have raised the taxes of middle income people by a larger percentage than it would have raised the taxes of the wealthy, and it raised the taxes of the poor by the largest percentage of all. It also contained a series of substantial new tax loopholes for wealthy investors.

In addition, the summit agreement would have placed significant burdens on elderly and disabled Medicare beneficiaries, raising beneficiary co-payments some $30 billion over the next five years. It also would have cut unemployment

insurance benefits at a time when the nation is entering a recession, making jobless workers wait two weeks before they could begin collecting benefits.

Finally, the summit plan contained no initiatives to assist low income households. Proposals before Congress to extend Medicaid coverage to more poor children and to improve the nation's food assistance program both would have been dropped.

In virtually all these areas, the final budget legislation is more progressive than the summit plan. It contains about the same level of deficit reduction as the summit agreement -- nearly $500 billion over five years -- but achieves these savings in a different manner.

The tax increases it contains are progressive. The tax burdens of the very wealthy will go up by a significantly larger percentage than will the tax burdens of the middle class. And the average tax burden of households with incomes below $20,000 will actually *decline*, as a result of major expansions in tax credits for low income working families with children.

In addition, the increases in out-of-pocket costs borne by Medicare beneficiaries are reduced two-thirds, from $30 billion over five years to $10 billion. The beneficiary cost increases in the final package are quite modest. In addition, Medicare beneficiaries who are poor, as well as some of the near-poor, are shielded from higher out-of-pocket costs.

The proposed cut in unemployment benefits is deleted. As a result, all federal programs targeted primarily at poor or unemployed people are protected. None of these programs are reduced.

Finally, the package contains the largest array of improvements in programs for low income people in more than a decade. Medicaid coverage will gradually be extended to all poor children through age 18. Low income working families with children will receive $18.3 billion over the next five years in new or expanded tax credits. The expanded tax credits will bring working poor families with children somewhat closer to the poverty line and will also defray a modest portion of the out-of-pocket costs that some low income working families incur to purchase health insurance. Two new grant programs are established allocating funds to states for providing child care services to low and moderate income families. And Medicaid services are expanded for functionally impaired elderly people living at home, rather than in an institution. No improvements in food stamps or other food assistance programs are included, however.

In addition, the fiscal year 1991 appropriations bills that accompanied the budget package contain increases for a number of additional low income programs, including Head Start, compensatory education for disadvantaged children, low income housing programs, and the WIC program.

The tax and entitlement expansions for low income people in the budget are targeted largely on one low income group: working families with children. Since poor children in welfare families are already covered under Medicaid, the Medicaid expansions in the package will primarily assist children in working poor families. The low income tax credit expansions and the new child care grant programs also are aimed at working families. Some new benefits are included for low income elderly people, but these generally are modest. By contrast, none of the expansions -- except for the appropriations increases for programs like Head Start and WIC -- are likely to have a significant effect on other groups of poor families, such as those receiving public assistance.

Shortcomings of the Budget Plan

The package also has less attractive elements. It precludes any peace dividend from materializing until at least fiscal year 1994. It also makes changes in budget procedures that shift more power from Congress to the Office of Management and Budget.

In these areas, the final package retains most of the features of the summit agreement, with little change. During the summit negotiations, the White House insisted on relatively high spending ceilings for defense. The White House also sought the establishment of separate ceilings on defense and domestic non-entitlement spending for each of the next five years, along with a prohibition on transferring any funds between these categories. The White House ultimately won higher defense spending ceilings than what many experts believe is needed, given the end of the Cold War. Partly as a result, the defense authorization and appropriations bills for FY 1991 that Congress passed just before adjourning fail to cancel a single major weapons system.

The White House proposal to bar the transfer of any funds between the defense and domestic spending parts of the budget was also approved, although the proposal was scaled back. The transfer of funds between these categories is prohibited for the next three years, rather than for the full five-year period the White House had sought. This provision prevents any peace dividend, or shifting of funds from the Pentagon to meet unaddressed domestic needs, until fiscal year 1994 at the earliest. Until then, domestic non-entitlement programs will compete

with one another for a fixed amount of funds, making it more difficult to find funds for new initiatives.

The final package also alters the federal budget process, with mixed results. The Gramm-Rudman-Hollings law is revised in such a way that across-the-board spending cuts under the act are virtually precluded for the next three years. During this period, the emphasis in the budget process will shift from meeting fixed deficit targets each year to blocking new spending that would increase the deficit. Any breach of the spending ceilings for defense or domestic non-entitlement programs will trigger an across-the-board cut in that particular category of programs. The cut will be set at the precise level needed to bring spending back under the ceiling for that program category. Similarly, no entitlement program can be increased, and no taxes cut, unless such measures are offset by other entitlement and tax changes that fully offset the new costs. Since the Office of Management and Budget will be the arbiter of whether the spending ceilings have been breached -- or whether new tax or entitlement initiatives have been "paid for" in full -- OMB will gain new powers.

Outline of this Report

This report presents the basic elements of the final budget package, with an emphasis on provisions important to low and moderate income people. Chapter II provides an overview of the package, showing the amount and proportion of savings achieved through tax increases, entitlement cuts, and reductions in non-entitlement spending. Each of the five subsequent chapters examines a particular budget area. These chapters cover tax provisions, entitlement provisions, the treatment of domestic non-entitlement programs, defense spending, and changes in budget procedures.

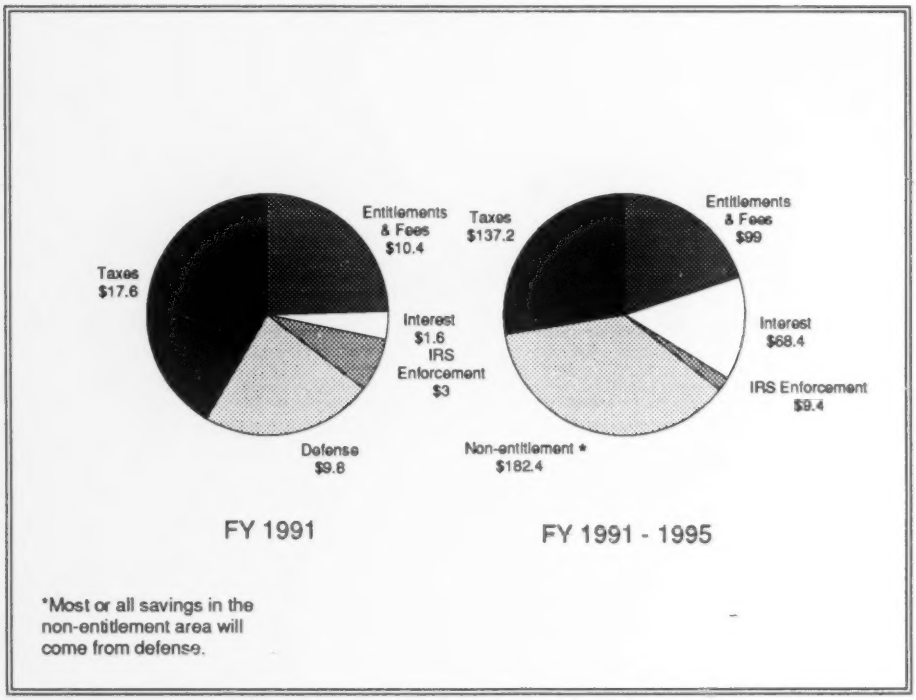
II. Overview of the Budget Legislation

On October 27, the House of Representatives and the Senate approved sweeping budget legislation making changes in numerous entitlement programs, raises taxes, places ceilings on spending for defense and domestic non-entitlement programs, revises the Gramm-Rudman-Hollings deficit targets, and makes other changes in Congressional budget procedures. The following day, Congress approved the last of 13 appropriations bills for fiscal year 1991 setting specific funding levels for hundreds of programs. Taken together, these measures are designed to reduce the deficit by $42.6 billion in fiscal year 1991 and $496 billion over the next five years.

The deficit reduction measures consist of five key elements: reductions in entitlement programs; reductions in defense spending; increases in user fees for government services; tax increases; and reduced interest payments on the national debt. Interest payments on the debt will be reduced both because the government will need to borrow less money and because interest rates are expected to fall as a result of the new legislation.

Some $19.5 billion of the $41 billion in deficit reduction (other than the deficit savings resulting from lower interest payments on the national debt) in FY 1991 will come from spending reductions. Within the spending area, entitlement programs are cut $9.7 billion in FY 1991, while defense spending is reduced $9.8 billion. All incremental funding for Operation Desert Shield in the Persian Gulf, however, will be in addition to the defense spending levels in the new budget measure. As a result, total defense spending -- including the costs for military operations in the Persian Gulf -- will be reduced by a smaller amount. An additional $700 million in FY 1991 deficit reduction will result from increases in user fees charged for various government services.

Figure 1
Deficit Reduction
FY 1991 and FY 91-95



An additional $17.6 billion in deficit reduction during FY 1991 comes from revenue increases. Another $3 billion is assumed to materialize from greater enforcement efforts and management reforms by the Internal Revenue Service. The final $1.6 billion in FY 1991 savings is expected from lower interest payments on the national debt.

Over five years, revenue increases would equal 32 percent of total deficit reduction (other than the deficit savings resulting from lower interest payments on the national debt). Spending reductions, including increases in user fees, would constitute 66 percent. From FY 1991 to FY 1995, tax increases would total $137.2 billion. The entitlement cuts and increases in user fees would total $99 billion. In addition, non-entitlement programs would be reduced a total of $182 billion, with most or all of this reduction coming from defense spending. (See table on next page.)

Table I
Deficit Reduction in Final Budget Legislation
(in billions of dollars)

	FY 1991	FY 91-95
Non-entitlement programs		
Domestic	--- }	
International	--- }	182.4*
Defense	9.8 }	
Entitlements and User Fees	10.4	99.0
Entitlements	9.7	92.1
User Fees	0.7	6.9
IRS Initiative	3.0	9.4
Tax and receipt measures	17.6	137.2
Interest payments	1.6	68.4
Total deficit reduction	42.6	496.3

*In FY 1994 and FY 1995, there would be one overall spending ceiling for all non-entitlement programs, including both defense and non-defense programs. This issue is explained in Chapter III. Totals do not add due to rounding.

III. Taxes

The tax provisions of the final budget package stand out in two respects. First, they are progressive, raising the taxes of the wealthy by a larger percentage than those of the middle class or the poor. Second, they include substantial increases in tax benefits for low income working families with children, primarily through a large expansion of the earned income tax credit.

Tax Progressivity

Under the September budget summit agreement, the taxes of people with incomes below $10,000 would have been raised by more than four times as great a percentage as the taxes of those making more than $200,000. The tax burdens of people in the $20,000 to $30,000 range would have climbed by twice as great a percentage as the tax burdens of people making more than $200,000.

The final budget package reverses this pattern. It imposes the largest tax increases on those at the top of the income scale. While average tax burdens will rise about two percent for families in the $20,000 to $50,000 range, they will climb 6.3 percent -- three times as great a percentage -- for those with incomes exceeding $200,000. Moreover, the average tax burden of households with incomes below $20,000 will actually decline, thanks to new tax credits for low income working families. (See Table II.)

Table II
Percent Change in Federal Taxes

Income Level	Final Package	Summit Agreement	House	Senate
Less than $10,000	-2.0%*	7.6%	-1.3%	0.0%*
$10,000 - 20,000	-3.2*	1.9	-1.6	-2.3*
$20,000 - 30,000	1.8	3.3	1.0	2.7
$30,000 - 40,000	2.0	2.9	1.0	2.8
$40,000 - 50,000	2.0	2.9	0.8	2.8
$50,000 - 75,000	1.5	1.8	1.4	1.9
$75,000 - 100,000	2.1	2.1	1.5	2.5
$100,000 - 200,000	2.3	1.9	0.7	3.5
$200,000 and over	6.3	1.7	7.4	3.7

*Includes child care bill, with approximately $12 billion in tax credits primarily for working families with children and incomes under $20,000.

Source: Center on Budget and Policy Priorities calculations, based on data from the Joint Committee on Taxation

Another way to look at progressivity is to examine the share of the new tax burdens that various income groups will bear. Some 46 percent of the new taxes levied on individuals -- as distinguished from those to be paid by businesses -- will be paid by taxpayers with incomes exceeding $200,000. This means nearly half of the new taxes will be paid by the richest one percent of the population. Meanwhile, the 85 percent of all taxpayers with incomes below $50,000 will shoulder just 19 percent of the new taxes.

By contrast, under the original budget summit agreement, taxpayers with incomes above $200,000 would have paid only 11 percent of the new taxes. Those with incomes below $50,000 would have borne 57 percent of the tax hikes. (See Table III.)

Table III
How Much of the Tax Increase
Is Borne by Various Income Groups

Income Category	Final Package*	Summit Agreement	House	Senate*
Under $50,000	19%	57%	11%	34%
$50,000 to $100,000	22	22	22	24
$100,000 to $200,000	13	10	5	18
$200,000 and over	46	11	63	24

* Includes effects of the tax provisions of the child care bill.

Source: Center on Budget and Policy Priorities calculations, based on data from the Joint Committee on Taxation.

Cautions about Progressivity

The impact of the new tax provisions in restoring more progressivity to the tax code should not be overstated, however. While the new tax provisions are quite progressive, their impact on the overall federal tax code is small. The relative proportions of the total federal tax burden borne by different income groups change only a tiny fraction under the new legislation.

In addition, the wealthy will retain most of the large tax cuts they received during the Reagan era. While the taxes of the richest one percent of households will rise about six percent under the new plan, these households received an average tax cut of more than 14 percent between 1980 and 1990, according to the Congressional Budget Office. Thus, the new legislation recaptures less than half of the large tax breaks given to those at the top of the income scale during the 1980s.

Finally, the tax picture at the bottom of the income scale is not as bright as it might appear. The average tax burdens of people with incomes below $20,000 will decline when these people are considered *as a group*. However, this decline is due entirely to the new tax credits for low income working families with children. Most other low income households will see their taxes rise -- and their disposable incomes fall -- as a result of the increases in the gasoline tax and other excise taxes.

Moreover, most of the new tax credits for low income working families already were moving through Congress as part of a child care bill. These provisions were supposed to bring working poor families closer to the poverty line and help them buy health insurance. Instead, a sizable share of the benefits from these provisions will be used to offset the higher excise taxes that low income working families will have to pay.

Revenue Raising Provisions

The new legislation raises $18 billion in new taxes in fiscal year 1991 and $137 billion over five years. The $137 billion figure is a *net* figure. The legislation raises more than $164 billion in new taxes, but also includes measures, such as the expanded low income tax credits, that reduce taxes by $27 billion over the five years.

The portion of the new revenues coming from higher excise taxes on gasoline, alcohol, and tobacco is considerably smaller than under the September

budget summit agreement. Conversely, the tax increases imposed on upper income Americans are substantially larger than in the original plan.

Taxes on Higher Income Groups

Nearly $69 billion in revenue is raised over five years through tax changes aimed at affluent taxpayers. The majority of these tax changes are designed to raise the income taxes that high income households pay.

A new income tax rate of 31 percent is established. It will apply to adjusted gross income in excess of $82,050 for couples filing joint returns.[1] In addition, itemized deductions are reduced for taxpayers with incomes in excess of $100,000. For every $10,000 these taxpayers have in income above the $100,000 benchmark, they lose $300 in itemized deductions.

Higher income taxpayers also lose the tax benefits of the personal exemption. The value of the personal exemption, which is normally claimed for each person in a taxpayer's "filing unit," will be reduced gradually as a taxpayer's income rises above $150,000 for couples filing joint returns. When income reaches $272,500, the value of the personal exemption is reduced to zero.[2]

Still another change stiffens the "alternative minimum tax." This feature of the tax code is designed to prevent wealthy people from escaping taxation by

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[1] In tax year 1991, the 31 percent marginal tax rate applies to income above $49,200 for single tax filers and above $70,350 for single heads of households. The marginal tax rate is the rate at which the last dollar of income earned is taxed.

[2] For single taxpayers, the value of the personal exemption will begin being reduced when income exceeds $100,000 and will be reduced to zero when income reaches $222,500. For single heads of households, the personal exemption will begin being phased down when income exceeds $125,000 and will be reduce to zero when income reaches $247,500.

Because of this phase-out of the personal exemption, there will still be a "bubble" in the tax code. This means that taxpayers whose incomes fall in the range over which the personal exemption is being phased out will face a steeper marginal tax rate than taxpayers at higher income levels.

For example, a married couple with adjusted gross income of $140,000 would face a 31 percent marginal tax rate. However, if the couple had income between $150,000 and $272,500 -- the income range over which the value of the personal exemption is reduced as income rises -- its marginal tax rate would be higher. If such a couple claimed four personal exemptions, its marginal tax rate would be about 33 percent. Once income passed the $272,500 level -- and personal exemptions were fully phased out -- the marginal tax rate would return to 31 percent. A couple with income of $300,000 would have a 31 percent marginal tax rate, while a couple with income of $200,000 would have a marginal rate of approximately 33 percent.

claiming so many deductions, credits, and other tax write-offs that they pay little or no taxes. Finally, no future medical deductions will be allowed for the costs of cosmetic surgery.

These changes in the income tax structure raise $40 billion over the next five years. Two of these provisions -- the modest cut in itemized deductions for taxpayers over $100,000 and the phase-out of personal exemption for those at even higher income levels -- will expire at the end of five years unless legislation is passed to extend them.

The other major provision aimed at upper income taxpayers raises the amount of income on which Medicare payroll taxes are paid. In 1990, taxpayers pay Social Security and Medicare payroll taxes on their first $51,300 in earnings, a level that had been scheduled to rise with inflation to $53,400 in 1991. The budget plan leaves the Social Security payroll tax unchanged, so that Social Security taxes will still be paid on the first $53,400 of earnings next year. However, the law significantly alters the Medicare payroll tax. Starting in 1991, taxpayers will pay Medicare payroll taxes on their first $125,000 in earnings.

Capital Gains Taxes

During the months of budget negotiations on the budget, the White House pushed hard for a deep cut in capital gains taxes. This effort failed, primarily because a cut in the capital gains tax would heavily benefit the wealthy.

The final legislation does, however, contain a modest change in the treatment of capital gains income. Under the Tax Reform Act of 1986, capital gains income is taxed the same as other income. This feature of the 1986 law, which eliminated the favorable treatment for capital gains income that had long been a part of the tax code, was one of the major reform elements of that law. It is widely credited with having helped to reduce the use of tax shelters substantially.

Unfortunately, the new legislation reinstates the practice of taxing the capital gains income of wealthy taxpayers at a lower rate than their other income. Wealthy investors in the top income tax bracket will face a 31 percent tax rate on other income, but a 28 percent rate on their capital gains income. While this difference in tax rates is modest, it could lead to some increase in tax sheltering. It may also encourage capital gains proponents to continue pushing vigorously for a much lower capital gains tax rate in the future. Still, this is markedly different from the much larger capital gains tax cut sought by the White House. The White House proposal would have slashed the capital gains tax rate to 15 percent, or about in half.

Since the Medicare payroll tax equals 1.45 percent of earnings, individuals who earn $125,000 or more will pay the 1.45 percent tax on an additional $71,600 in earnings next year. As a result, these people will pay an additional $1,000 a year in Medicare payroll taxes. This change in the Medicare payroll tax raises nearly $27 billion over five years.

The final tax increase aimed at upper-income individuals is a new 10 percent luxury tax on high-priced cars, boats, jewelry, furs, and private airplanes. The luxury tax raises little money, however -- just $1.5 billion over five years -- because it contains numerous exemptions. Most private airplanes will be exempt, as will boats and yachts that sell for less than $100,000. The tax will apply to: amounts in excess of $30,000 paid for new cars; amounts in excess of $100,000 paid for private boats and yachts; in limited circumstances, amounts above $250,000 paid for private airplanes; and purchases of more than $10,000 for jewelry and furs.

Excise Taxes

The new law contains five major excise tax provisions.

- An increase, effective December 1, 1990, of five cents a gallon in the tax on gasoline and other motor fuels.

- An increase in the cigarette tax from the current rate of 16 cents a pack to 20 cents a pack in 1991 and 24 cents a pack in 1993.

- An increase in taxes on alcohol. The tax on beer would rise by 16 cents a six-pack, while that on wine would rise by 18 cents a bottle. Taxes on liquor would increase about 20 cents a "fifth."

- An extension and increase in airport and aviation excise taxes, including an increase from eight percent to ten percent in the tax on airline tickets.

- The new law also makes permanent the current three percent federal excise tax on telephone service, which was scheduled to expire at the end of 1990.

While these excise tax increases raise $65 billion over five years, they should be viewed as modest. For example, an individual who drives 10,000 miles a year and gets 25 miles to the gallon will pay $20 more for gasoline on an annual basis. An individual who consumes two six-packs of beer each week will pay about $17 more each year in beer taxes. Someone who smokes a pack of cigarettes a day

will pay $29 a year more in tobacco taxes, once the eight-cent per pack increase is phased in fully. The telephone tax does not pose new burdens, since it is an extension of a tax already in place. (The total impact of the increase in the gasoline tax will be somewhat greater than $20, because higher gasoline prices will result in small increases in the prices of other items that must be transported, such as food items.)

The excise tax increases in the budget are considerably smaller than those contained in the original summit agreement. This is primarily because the gas tax increase was cut from 12 cents a gallon to five cents. In addition, the summit proposal to levy a two-cent per gallon tax on other petroleum products, including home heating oil, was dropped.

One other item is worthy of note. As an environmental measure, the final budget legislation doubles the current $500 tax on new "gas guzzling" automobiles. A new car is considered a gas guzzler if it gets fewer than 22.5 miles per gallon.

Other Tax Increases

The legislation also contains a number of smaller tax increases. Most notable are: a provision requiring all state and local government employees not otherwise covered by a retirement plan to pay Social Security taxes; a provision extending a small tax that employers pay into the unemployment insurance trust fund (this tax would otherwise expire; it needs to be extended to keep unemployment insurance trust fund reserves at an adequate level during the coming recession); higher taxes on insurance companies; and an increase in the interest rate that corporations are charged when they are late in paying their taxes. These four provisions raise another $24 billion over five years.

Tax Credits For Low Income Working Families

Of the various tax and entitlements provisions that benefit low income people, the largest are the expansions in tax benefits for low income working families with children. The budget law contains $18.3 billion over the next five years in new tax benefits for these families. In other words, $18.3 billion will be placed in the pockets of low income working families through the workings of the tax code.

Over the long term, the increases in tax benefits are even larger than these numbers suggest. The increase in the earned income credit is phased in over the next five years, with much of the increase not occurring until the fifth year. In

fiscal year 1995 alone, the increase in tax credit benefits for low income working families is $7.3 billion, a level that will remain in place for years after 1995.

The Earned Income Tax Credit

Most of the increase in low income tax benefits -- $13.1 billion over five years -- comes through expansion of the earned income tax credit. EITC benefits eventually will be raised about 70 percent.

The EITC is a tax credit available to working families with children that have incomes below about $20,000. For tax year 1990, the income cut-off is $20,264; for tax year 1991, it will be about $21,100. The credit is "refundable." This means that if a family earns too little to owe federal income tax -- or if the amount of the credit exceeds the income tax the family owes -- the IRS sends the family a check.

For tax year 1990, EITC benefits equal 14 percent of the first $6,810 in family earnings, resulting in a maximum EITC benefit of $953. EITC benefits remain at the maximum $953 level as family income rises from $6,810 to $10,730. As incomes rise above $10,730, benefits phase out slowly. The benefits fall to zero when income reaches $20,264.

The new legislation enlarges the EITC in three ways: 1) it increases EITC benefits for all eligible families; 2) it adds a further benefit for families with two or more children, and 3) it adds a supplemental benefit for families with a child under one year of age.

Under the new law, the EITC benefit for tax year 1991 will equal 16.7 percent of the first $7,140 for earnings for a family with one child, and 17.3 percent of the first $7,140 in earnings for families with two or more children. As a result, the maximum basic EITC benefit will rise from $953 for tax year 1990 to $1,192 for tax year 1991 for families with one child, and to $1,235 for families with two or more children. The family will also receive a new, supplemental EITC benefit -- equal to an additional five percent of the first $7,140 in earnings -- if the family has a child under one year old. A family with a child under age one thus receives a supplemental EITC benefit of up to $357.

These EITC increases grow larger each year until they phase in fully for tax year 1994. At that point, the basic EITC benefit will equal 23 percent of about the first $8,100 in earnings for a family with one child, and 25 percent of the first $8,100 in earnings for families with two or more children. For tax year 1994, the maximum credit thus should equal about $1,860 for a family with one child and

$2,025 for a family with two or more children. In addition, the supplemental benefit for families with a child under age one should reach a maximum of about $405 -- or five percent of the first $8,100 in earnings for tax year 1994.

The new law makes the EITC more attractive in another way as well. It stipulates that EITC benefits cannot be counted as income in determining eligibility or benefit levels for AFDC, SSI, Medicaid, food stamps, or subsidized housing programs, including rural housing programs. While the EITC was already disregarded as income in a number of these programs, EITC benefits could, make a family ineligible for AFDC -- or cause a family's rent to rise if it lived in subsidized housing -- for the month in which the EITC payment was received. Now, that will no longer happen.

Table IV
The New EITC Benefit Structure

	Family With One Child		Family With Two or More Children		Supplemental Credit For Families with a Child under One	
Tax Year	Credit Percentage	Maximum Benefit	Credit Percentage	Maximum Benefit	Credit Percentage	Maximum Benefit
1990	14% of first $6,810	$953	14% of first $6,810	$953	—	—
1991	16.7% of first $7,140	1,192	17.3% of first $7,140	1,235	5% of first $7,140	$357
1992	17.6% of first $7,440	1,309	18.4% of first $7,440	1,369	5% of first $7,440	372
1993	18.5% of first $7,760	1,436	19.5% of first $7,760	1,513	5% of first $7,760	388
1994	23% of first $8,090	1,861	25% of first $8,090	2,023	5% of first $8,090	405

Note: Dollar amounts for 1991 and beyond are based on current CBO estimates of inflation (using the Consumer Price Index). Precise dollar amounts may vary when inflation estimates are revised.

Furthermore, the legislation repeals the rules under which poor working families on AFDC used to be disqualified for the EITC if their AFDC benefits exceeded their earnings. Such families will now be able to qualify for the EITC on the same basis as other low income working families.

One other EITC change is likely to cause some problems, however. Starting with tax returns for 1991 -- that is, tax returns filed in early 1992 -- families will have to file a separate schedule to receive the EITC, in addition to their 1040 or 1040A form. Just as taxpayers claiming itemized deductions file a separate schedule along with their 1040 form, taxpayers claiming the EITC will need to attach a new EITC form.

This change was necessitated by a number of the other EITC revisions in the legislation which make it impossible to include, on the basic 1040 form, all of the information needed to determine EITC benefits. Requiring a separate form is likely to make EITC public information efforts particularly important in the future.

Low Income Health Insurance Credit

In addition to expanding the EITC, the new law establishes a new, refundable health insurance credit for low income working families with children. This credit is aimed at low income working families that pay premium costs for a health insurance policy that includes -- but is not necessarily limited to -- health care coverage for a child. The premium costs may be incurred either by purchasing health insurance coverage and paying full premiums, or by making co-payments for an employer-sponsored health plan.

The new tax credit is structured in a manner very similar to the EITC. Families will receive a tax credit equal to six percent of their first $7,100 in earnings (for a maximum credit of $426), except that the credit can not exceed the amount actually paid for health insurance premiums. The credit will begin to phase down at the same income level that EITC benefits begin to phase down, and will phase out at the same point that EITC benefits do. In fact, the new health insurance credit can be thought of as a supplemental benefit for EITC families that incur costs for health insurance premiums. And like regular EITC benefits, the benefits of the health insurance credit will not count as income in the AFDC, SSI, Medicaid, food stamp, and low income housing programs.

Only a modest fraction of families receiving the EITC are expected to qualify for the health insurance credit. Most of these are expected to be families that receive health insurance coverage through an employer but are charged co-payments for it. Relatively few families that otherwise lack insurance are expected to purchase it as a result of the new credit, since the credit will defray only a very small portion of the cost of a family insurance policy. Such policies now typically cost more than $3,000 if a family purchases the policy individually rather than as part of a group plan.

The health insurance credit is expected to provide $5.2 billion in benefits over the next five years to those low income working families that incur health insurance costs and thereby qualify for the credit.

Other Tax Issues

The new law contains several other tax provisions. On the positive side, it extends for a year the low income housing tax credit that was scheduled to expire at the end of 1990. The low income housing tax credit is the principal federal source of support for the construction of low income housing. The housing credit is one of a number of expiring tax provisions extended through the end of 1991 (and are likely be extended again next year).

On the negative side, the budget includes $3.3 billion over five years in new tax breaks for businesses and corporations, including $2.5 billion in new tax breaks for oil companies and other firms involved in energy production. However, this represents only one-fifth of the $17 billion in new tax breaks for wealthy investors, oil companies, and the like included in the September summit agreement.

What the Tax Package Demonstrates

It is often said that if large amounts of taxes need to be raised, the bulk of the taxes must come from the middle class because there simply are not enough wealthy individuals from whom to raise the revenues. The tax provisions of the new budget law suggest this "conventional wisdom" is not correct.

Nearly half of the new taxes in the law come from people with incomes over $200,000. Enough taxes were raised in this manner to hold the average tax increase on people in the $20,000 to $50,000 range to two percent and to provide substantial new tax credits for low income working families.

Yet the new law hardly overburdens wealthy taxpayers. Their federal tax burdens would rise an average of about six percent, less than half the percentage by which their taxes were cut in the 1980s. In addition, the Joint Committee on Taxation reports that under the new law, the effective tax rate -- that is, the percentage of total income paid in federal taxes -- would rise only slightly for people with incomes over $200,000 -- from 25.2 percent of income to 26.8 percent.

In short, the new legislation raises substantial amounts of revenue in a highly progressive manner -- and does so without "soaking the rich."

IV. Entitlement Changes

Reductions in entitlement programs and increases in user fees account for $99 billion in deficit reduction over the next five years. The largest entitlement cuts will occur in the Medicare program, which provides health insurance for the elderly and disabled. Substantial cuts are also made in farm price support programs, veterans programs, guaranteed student loans, and several other programs.

Despite the breadth of the entitlement reductions, low income families and individuals will not be affected much by these cuts. The bulk of the Medicare cuts fall on hospitals and doctors. Medicare beneficiaries will have to pay somewhat higher premiums and deductibles, but these increases are modest compared to the provisions contained in the September budget summit agreement. Moreover, state Medicaid programs will pay the Medicare premiums and deductibles for those Medicare beneficiaries who are poor. On the other hand, changes in the guaranteed student loan program and Federal Housing Administration mortgage insurance programs likely will have some adverse impacts on low income people, although the impacts are likely to be limited.

The budget package also includes several significant expansions in entitlement programs for low income people. The most striking is a major expansion in Medicaid coverage for poor children. The new law extends Medicaid so that by early in the next century, all poor children under age 19 will be eligible. The legislation also enables frail elderly people on Medicaid to receive a greater array of services without having to go into a nursing home.

In addition, the legislation reduces Medicare out-of-pocket costs for some near-poor elderly and disabled individuals. In fact, although the law achieves substantial savings through various cuts in entitlement programs, the overall effect

of the entitlement changes on low income households is to extend more benefits to them -- and to improve their conditions to a modest extent.

Changes in Medicare

The summit agreement would have required the nation's 33 million elderly and disabled Medicare beneficiaries to pay considerably more for the services they receive under Part B, the part of Medicare covering physician services.[3] This would have been done in three ways:

- The annual deductible for services under Part B of Medicare would have been raised from $75 per year to $150. Beneficiaries now pay the first $75 in costs before Medicare Part B coverage kicks in. The summit agreement would have raised this to $150 in several stages.

- Beneficiaries would have been charged 20 percent of the cost of clinical laboratory services under Part B. Currently, Medicare pays these costs in full.

- The monthly premium for Medicare Part B services, which currently is set at $28.60 per month, would have been raised substantially -- to $33.40 per month in 1991 and $55.40 per month by 1995.

The House and Senate bills both reduced the scope of the increases in beneficiary payments, although the Senate plan required a substantially larger contribution from beneficiaries. The final package reflects the House provisions.

- The annual deductible for services under Part B of Medicare will rise from $75 to $100, rather than to $150. The $100 is *not* indexed for inflation, so unless subsequent legislation is passed raising the deductible further, it will remain at $100.

- No charges will be imposed for clinical laboratory services under Medicare Part B.

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[3] Part A of Medicare provides coverage for hospital services. The costs of Part A are paid out of the Medicare trust fund, which is financed by the Medicare payroll tax. The payroll tax does not fund the costs of Part B. These costs are paid for by general tax revenues and by beneficiary co-payments.

- Monthly premiums will increase at about the same rate as in recent years. Premiums will rise from the current $28.60 per month in 1990 to $29.90 in 1991 and $46.10 by 1995. (See Table V below.)

In recent years, the monthly premium has been set at a level equal to 25 percent of the average costs per beneficiary incurred in the Medicare Part B program. The new law sets the premiums for each of the next five years at the levels currently estimated to equal 25 percent of the average costs per beneficiary in these years.

Since the costs of medical care are rising faster than the overall inflation rate, Medicare Part B premiums will continue to outstrip inflation. Yet even here, the new law provides some protection for beneficiaries. The law specifies the exact level of the Medicare premiums for each of the next five years. If medical care costs rise faster than currently projected, the premiums will remain at the levels specified in the new law. As a result, future premiums could actually fall slightly below 25 percent of average cost per beneficiary.

Table V
Medicare Monthly Premiums
1990 - 1995

Year	Monthly Premium
1990	$28.60
1991	$29.90
1992	$31.80
1993	$36.60
1994	$41.10
1995	$46.10

The budget package also contains Medicare reductions aimed at doctors and hospitals. These reductions, which total $32 billion over five years, will limit the annual increase in Medicare reimbursement rates paid to doctors and hospitals to less than the full rate of inflation. Other changes designed to reduce Medicare payments to doctors and hospitals also are included.

The package includes provisions to help cushion the effect in rural and inner city areas of these reductions in hospital payments. The Medicare provisions of the legislation include approximately $1 billion in relief over five years to rural hospitals and another $1 billion to inner city hospitals.

Medicare Improvements

The new law also contains several Medicare improvements.

- The law adds a new service to Medicare -- routine mammography screenings. The addition of this service, which is estimated to cost $1.25 billion over the next five years, should help reduce the incidence of breast cancer.

- Changes in Medicare reimbursement policies also provide incentives for low-income Medicare beneficiaries to use preventive and primary care health services. Medicare beneficiaries will no longer incur out-of-pocket costs (for deductibles or co-payments) for such services at health care facilities, such as community health centers, that serve a large proportion of low income individuals.

- Near-poor Medicare beneficiaries are protected from the impacts of the increases in beneficiary out-of-pocket costs. Over time, the law actually will reduce their out-of-pocket costs.

The provisions protecting near-poor beneficiaries from increases in co-payments are of particular interest. Under 1988 legislation, the Medicaid program pays the Medicare premiums, deductibles and co-payments for Medicare beneficiaries with incomes below 90 percent of the poverty line. Under the 1988 law, this benefit was scheduled to be extended to beneficiaries with incomes between 90 percent and 95 percent of the poverty line in 1991 and to those with incomes between 95 percent and 100 percent of the poverty line in 1992.

Under the budget package, this benefit will be phased in more quickly and extended to more low income Medicare beneficiaries. On January 1, 1991, Medicaid will begin paying all cost-sharing for Medicare beneficiaries with incomes up to 100 percent of the poverty line. As a result, all poor elderly and disabled people on Medicare who apply to have Medicaid cover these out-of-pocket costs will be shielded from the increases in the new law.

Currently, many poor Medicare beneficiaries not enrolled in Medicaid apparently are unaware that Medicaid will pay the premiums and deductibles for them -- and have not applied to have these costs picked up. As a result, these people will be adversely affected by the increases in Medicare out-of-pocket costs, unless they learn their contributions can be paid for them and apply to have this done.

In addition, starting in January 1993, Medicaid will also be required to cover the Medicare premiums (but not the deductibles and co-payments) for beneficiaries with incomes between 100 percent and 110 percent of the poverty line. And starting in January 1995, Medicaid will pay the premiums for beneficiaries with incomes up to 120 percent of the poverty line. Thus, over time, near-poor Medicare beneficiaries with incomes slightly above the poverty line will have their Medicare out-of-pocket costs reduced.

The new legislation also establishes standards for "Medigap" insurance policies. These are private insurance policies that are designed to defray medical costs not covered by Medicare, such as charges for the first day of a hospital stay and prescription drug costs. The new law requires the National Association of Insurance Commissioners to draft 10 model Medigap policies. If the NAIC does not comply within nine months, the Department of Health and Human Services is instructed to draft the model policies. The law requires each private insurance company to sell these standardized policies. This will allow elderly consumers to easily compare the prices of policies sold by different companies.

In addition, the new law prohibits the sale of more than one Medigap policy to an individual and forbids the sale of Medigap policies to low income elderly people already covered by Medicaid.

Medicaid Changes

Two provisions in the budget package achieve savings in the Medicaid program. The first provision requires pharmaceutical companies to give state Medicaid programs discounts on certain types of drugs. States would be required to set up competitive bidding procedures and other cost containment mechanisms to get the lowest possible price for these drugs. For example, for drugs manufactured by a single company, the company must provide the drugs to Medicaid at the lowest price charged to other buyers of the drug. Currently, some companies charge Medicaid more for certain drugs than they charge other buyers, such as the Veterans Administration. This change will save $1.9 billion over five years.

An additional $1 billion in savings is projected from increased enrollment of Medicaid recipients in employer-sponsored health care plans. Under this provision, state Medicaid programs will pay the premiums and other co-insurance costs to enroll Medicaid recipients in an employer-sponsored plan where this can be done at a savings to Medicaid.

For example, some Medicaid beneficiaries have a parent or spouse receiving health insurance through an employer. Some states have found that Medicaid costs can be reduced by paying the premiums and other costs so that the Medicaid beneficiary can be covered under the relative's private insurance policy -- rather than continuing to pay through Medicaid for basic medical services for these family members. Medicaid still pays for medical services not covered under the employer plan.

Medicaid Expansions

The new budget law also contains significant Medicaid expansions. The budget resolution passed by Congress on October 8 granted the tax-writing committees some flexibility in meeting their deficit reduction targets. Committees were permitted to add new initiatives to the budget legislation if the costs of the initiatives were offset through other entitlement reductions or revenue increases. Both the House and the Senate took advantage of this opportunity to make substantial improvements in Medicaid, especially for poor children.

Under legislation enacted a year ago, states must extend Medicaid coverage to pregnant women, infants, and children under six with incomes below 133 percent of the poverty line. For children age six and over, however, the coverage rules have been much more restrictive. Most poor children age six or older are eligible for Medicaid only if their families receive AFDC. And in most states, AFDC income limits are set far below the poverty line.

The new budget legislation substantially broadens Medicaid coverage for children age six and older. It requires state Medicaid programs to cover children age six through 18 in families with incomes below 100 percent of the poverty line. The requirement is phased in over 12 years by extending coverage through the 19th birthday to poor children born after September 31, 1983. Thus, on July 1, 1991, state Medicaid programs will have to cover poor children born after September 31, 1983. By October 1, 2002, all poor children through 18 will be covered.

The budget package also makes several other modest improvements in Medicaid coverage. The package makes mandatory a current state option to provide continuous Medicaid coverage for a pregnant woman for two months after the end of her pregnancy, even if the woman would otherwise become ineligible during that period. In addition, a child born to a woman who was covered by Medicaid at the time the child was born will remain continuously eligible for Medicaid until the child's first birthday, so long as the child remains in the

mother's household and the mother remains eligible for Medicaid -- or would be eligible if she were pregnant).

In addition, the new legislation requires states to place Medicaid eligibility workers at additional locations other than welfare offices. This will allow women and children who do not receive AFDC to apply for Medicaid coverage at a location other than the local welfare office. States must place eligibility workers at hospitals that provide a disproportionate share of their services to people without health insurance and at community health centers.

Finally, the legislation establishes a new Medicaid program component for the frail elderly. The law provides $580 million over five years to allow states the option of covering home and community-based long-term care services for "functionally disabled" elderly individuals. These services could include personal care services, chore services, and nursing services for disabled elderly people and outpatient services for those with mental illness. Until now, Medicaid paid for such services only if the individual lived in a nursing home or a mental health institution (or if a state had a waiver allowing it to offer these services; states could be granted such waivers only if they could show that offering these services would entail no additional cost to Medicaid).

Guaranteed Student Loans

The new law saves $1.7 billion over five years in the Guaranteed Student Loan program. These reductions are achieved principally by removing from the program those schools in which more than 35 percent of the students have defaulted on their loan repayment obligations in each of the three most recent years for which data are available.

The legislation also requires students without a high school diploma or GED to pass an "ability to benefit" test to receive a GSL for a community college or a for-profit trade or vocational school. These tests must be approved by the Department of Education and administered independently from the school.

It is difficult to determine how these changes will affect low income students. There is cause for concern, however, since low income students are more likely than other students to default on student loans. In addition, a significant majority of the schools with default rates exceeding 35 percent are for-profit "proprietary" schools, many of which serve large numbers of low income students. Historically black colleges and tribal community colleges could also be hurt by these provisions, although these schools are exempt from the default rate

provisions until July 1994. Relatively few junior colleges, community colleges and four-year colleges are likely to be threatened.

The 35 percent default rate standard will limit the availability of federal student loans at many proprietary trade schools and low income students who attend such schools may not have alternative educational opportunities. If a school is ruled ineligible to participate in the GSL program, a low income student would still be eligible to receive a guaranteed student loan for use at another school with a lower default rate. As a result, it is not clear at this time how many low income students will lose educational opportunities under the new default rate standards.

FHA Programs

The new legislation saves $3.4 billion over five years in Federal Housing Administration programs, which provide subsidized mortgage insurance to low and middle income homebuyers.

The most significant change will increase out-of-pocket closing costs paid by homebuyers seeking FHA insurance. For a typical FHA-insured home of $65,000, homebuyers will have to put up an additional $800.

In addition, FHA will begin charging borrowers a new, risk-based premium. The more money that new homebuyers put into a downpayment, the fewer years they will have to pay the premium, which typically will amount to $12 to $15 per month.

Under these changes, between 35,000 and 100,000 fewer households are expected to get FHA mortgage insurance each year. No data are available on the incomes of those likely to be kept out of the program by these stiffened requirements. The incomes of current FHA borrowers vary widely. In the South and Midwest, typical incomes range from $10,000 to $30,000, according to the Senate Banking Committee. Along the East and West coasts, typical incomes are substantially higher, ranging from $30,000 to $60,000. Those families unable to participate as a result of the FHA program changes are likely to be families with relatively low incomes and that encounter the most difficulty in coming up with the increased up-front costs.

Other Entitlement Reductions

Other entitlement cuts in the package include:

	FY 1991	FY 1991 - FY 1995 (5-year total)
	(in billions of dollars)	
Farm price supports	1.2	11.9
Other farm programs	0.4	3.0
Civil service retirement	1.4	7.6
Postal service retirement benefits; federal employee health benefits	0.9	6.6
Veterans programs	0.6	3.7

The reductions targeted at the U.S. Postal Service are likely to increase the price of stamps. Postmaster General Anthony M. Frank was quoted in the *Washington Post* saying that reductions in the budget summit agreement would increase stamp prices by five cents by 1995.

Additional Entitlement Issues

The budget legislation does not impose new restrictions on the unemployment insurance program. The September summit agreement included a requirement that states make applicants for unemployment insurance benefits wait two weeks before receiving any assistance, but this provision was dropped.

The final legislation also makes no changes or improvements in the food stamp program. The FY 1991 budget resolution passed last spring by the House of Representatives included $5 billion over five years for improvements in food stamps and other low income food assistance programs. These improvements were then reflected in the Mickey Leland Memorial Domestic Hunger Relief Act, passed by the House in early August as part of the farm bill. The Leland Act, targeted principally at poor children and their families, would have made the most significant improvements in domestic food assistance programs in 13 years. However, funds for the Leland Act were eliminated during the budget summit

negotiations at the insistence of the White House and were not subsequently restored.

The budget package does contain some minor improvements in the Supplemental Security Income program for the aged and disabled poor and in AFDC. For example, the legislation extends until October 1, 1991 a provision of existing law that bars the Department of Health and Human Services from issuing new, more restrictive policies regarding the use of emergency assistance or special needs funds under AFDC. The new law also makes the use of monthly reporting and retrospective budgeting procedures in AFDC a state option. Until now, states have been required to use these procedures for certain types of AFDC families. A number of studies have found that these procedures can lead to the loss or interruption of benefits for some needy families and can also result in higher state administrative costs.

Finally, the legislation establishes a new "capped" entitlement program under which the federal government will provide states up to $300 million a year to pay for child care services for low income working families at risk of becoming welfare recipients. This program is covered in more detail in Chapter V of this report.

V. Domestic Non-Entitlement Programs

The budget package does not require cuts in domestic non-entitlement programs. Instead, it allows for a modest increase in spending, and a number of low income programs did receive funding increases for fiscal year 1991.

However, the new law contains another significant feature for domestic programs: it prohibits the shifting of any funds from defense to domestic programs for at least three years. As a result, further increases in domestic non-entitlement programs in fiscal years 1992 or 1993 must be "paid for" with reductions in other domestic non-entitlement areas. Essentially, the budget package assures that there can be no significant "peace dividend" until fiscal year 1994, at the earliest.

Spending Ceilings

The budget legislation establishes ceilings on the total amounts that can be appropriated and spent for domestic non-entitlement programs in each of the next three years, or fiscal years 1991 through 1993. Separate ceilings are established for defense and for foreign affairs programs. During these years, funds cannot be moved from defense to domestic programs, even if the crisis in the Persian Gulf ends swiftly.

In fiscal years 1994 and 1995, one overall ceiling is set for *all* non-entitlement programs, including both defense and domestic programs. In these years, defense appropriations could be reduced further to free up funds for unmet domestic needs. However, since some major elements of defense spending, like weapons contracts, result in costs over several years, it will be difficult to achieve a large additional defense reduction just between FY 1993 and FY 1994. As a

result, it will likely be the mid-1990s before any significant peace dividend can materialize.[4]

Some news accounts have reported that total funding for domestic non-entitlement programs will be held, during fiscal years 1991 through 1993, at the FY 1990 level, adjusted for inflation. These reports suggest there is no room for any increase during the next three years. In reality, the agreement does have room for some modest growth in domestic non-entitlement funding in these years. The confusion results because the original budget summit documents issued by OMB showed the FY 1991-FY 1993 ceilings for domestic non-entitlement programs exactly equaling the FY 1990 level, plus inflation.

It now appears that these OMB figures were incorrect. Data from the Congressional Budget Office indicate that the new budget ceilings allow appropriations for domestic non-entitlement programs in FY 1991 to rise about $5 billion above FY 1990 levels, after adjustment for inflation.

As a result, a number of domestic programs, including some low income programs, received funding increases when the FY 1991 appropriations bills were written. These increases are discussed in more detail below. It is unlikely there will be room for a comparable increase in domestic non-entitlement funding in fiscal years 1992 or 1993, however. The spending ceilings for these years do not allow much room for domestic non-entitlement spending to rise beyond adjustments to keep pace with inflation.

Moreover, as the economy heads toward recession, unemployment and poverty levels are likely to rise, increasing the numbers of Americans needing various services. In the years ahead, a variety of unmet domestic needs will be pitted largely against each other -- and against existing domestic non-entitlement programs -- in a competition for limited resources. Since no funds can be transferred from other budget areas, increases in one domestic non-entitlement program will, to a significant degree, require reductions in another.

Child Care

The new budget is particularly significant in one domestic entitlement area, the provision of child care services. For several years, child care advocates worked to establish new child care programs supported by federal funds. In late

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[4] The new law also prevents, for the next five years, the shifting of funds to non-entitlement programs from any other part of the budget. Thus, it will not be possible to secure more funds for non-entitlement programs during this period by raising taxes or cutting entitlements.

October, the child care legislation was incorporated into the budget bill. The final package creates two new programs of grants to states for child care services.

The larger of the two programs is the Child Care and Development Block Grant program designed to increase the availability, affordability, and quality of child care. The legislation authorizes $750 million in FY 1991, $825 million in FY 1992, $925 million in FY 1993, and "such sums as necessary" for fiscal years 1994 and 1995. Block grant funds will be allocated among states under a formula based on two factors: the number of children in each state below age five and the number of children receiving free or reduced-price lunches under the school lunch program.

For FY 1991, $732 million was appropriated for the child care block grant program. Future funding will be set each year through the annual appropriations process. Since total funding for domestic non-entitlement programs in fiscal years 1992 and 1993 is limited under the new spending ceilings, the child care block grant program will compete for funds during the next two years with other domestic non-entitlement programs.

The legislation establishing the new block grant program requires states to spend 75 percent of their block grant funds for direct assistance to parents for child care services and for efforts to increase the supply and improve the quality of child care services. Direct assistance can be provided to families with children under age 13 and incomes below 75 percent of their state's median income. In an average state, 75 percent of median family income equalled between $25,000 and $26,000 in 1989. The amount of assistance provided to a family will be based on a sliding fee scale established by the state.

The remaining 25 percent of block grant funds is to be spent for grants and contracts with providers of early childhood development services and/or providers of before-school and after-school child care services. In addition, states must use a portion of this 25 percent for activities to improve the quality of child care. Such activities may include the development or expansion of referral programs, assistance to providers to help them meet state and local child care standards, improvement in monitoring and enforcement of state standards and licensing requirements, the provision of training and technical assistance, and improvements in salaries of child care workers.[5]

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[5] To receive funds, a state must submit a comprehensive child care plan that includes the designation of a lead agency, a process for local consultation in developing the plan, and plans to coordinate with existing child care programs. Providers receiving state grants or contracts must be licensed, regulated, or registered before they can receive payment. State plans must also establish health and safety requirements for all providers that receive state grants or contracts. In addition,

(continued...)

The second new child care grant program is a "capped" entitlement program authorized under Title IV of the Social Security Act. Up to $300 million a year will be allocated to states to provide child care services for low income families that are not on AFDC, but that need child care assistance to work and are at risk of becoming welfare recipients if they do not receive such assistance. Recipients of this program would not also receive direct benefits from the child care block grant program.

States will have considerable flexibility in designing and operating this program. For example, a state could elect to use funds to extend the time a mother can receive child care assistance after working her way off welfare. Under the welfare reform law, child care assistance is limited to a 12-month transition period after a mother leaves the welfare rolls.

To receive funds under the new Title IV program, states must put up matching funds. The federal-state matching rates are the same as those used for AFDC and Medicaid benefits. Some states probably will provide only limited matching funds and will not use all the federal child care funds to which they are entitled. As a result, the Congressional Budget Office estimates that $715 million in federal funds actually will be spent under the program over the next five years, even though $1.5 billion is made available.

Low Income Appropriations

Since the FY 1991 spending ceiling for domestic non-entitlement programs allowed room for some growth, several low income programs received funding increases this year. Programs receiving substantial increases above current service levels include:

Child Care: As noted, the new child care block grant program received $732 in FY 1991 appropriations.

Head Start: The FY 1991 appropriation for the Head Start program is $1.95 billion, an increase of $338 million over the current services level. (The current services level equals the previous fiscal year's funding, plus an inflation adjustment.)

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[5] (...continued)

the legislation requires states to conduct a one-time review of state licensing and regulatory requirements, unless the state has done so within the last three years.

Compensatory Education for Disadvantaged Children (the Chapter 1 program): Some $6.2 billion in FY 1991 funds were appropriated for compensatory education, an increase of $642 million above the current services level.

McKinney Homeless Assistance Programs: Programs under the Stewart B. McKinney Homeless Assistance Act are funded at $681.8 million in FY 1991, an increase of $79 million over the current services level. Most of the increase went to four program areas: the Primary Care and Substance Abuse program; special grants for the homeless administered through the Community Service Block Grant program; a program to rehabilitate single room occupancy hotels for the homeless; and a program to provide transitional and handicapped housing for the homeless.

WIC: Some $2.35 billion was appropriated for WIC in FY 1991, an increase of $139 million over the current services level. However, this funding increase will only bring WIC participation back to the level attained in March of 1990. Since then, more than 100,000 women, infants, and children have been removed from WIC due to higher-than-anticipated increases in the prices of WIC foods. With this funding level, approximately 53 percent of those eligible for WIC will receive benefits in an average month in FY 1991.

Low Income Housing: Subsidized housing programs will receive $9.3 billion in appropriations for FY 1991, an increase of $1.5 billion over the current services level. As a result, the number of additional low income households receiving assistance will rise from 75,500 in FY 1990 to 95,000 in FY 1991. However, this remains far below the 316,000 additional low income households assisted in an average year in the late 1970s, before severe cutbacks in low income housing programs during the Reagan Administration.

A large portion of the increase in funds for subsidized housing will be used to bolster public housing programs. Some $527 million is provided to modernize public housing projects. Other increases will fund construction of 10,000 new public housing units, along with 3,000 new Indian housing units. This represents an increase of more than 60 percent over the number of public housing units built with FY 1990 funds. Public housing authorities also will receive $160 million above the current services level to help defray operating expenses of public housing projects. New housing units made available under the section 202 program, which provides housing for the low income elderly, also will increase.

Modest increases in funds are provided for housing vouchers and certificates, the basic form of housing assistance for low income tenants, and for the Community Development Block Grant program. Some $3.2 billion in CDBG funds have been provided for FY 1991, a five percent increase over the FY 1990 level plus inflation.

Other domestic program areas receiving substantial funding increases include: the Alcohol, Drug Abuse and Mental Health Administration; the Federal Aviation Administration; the Drug Enforcement Administration; the National Aeronautics and Space Administration; and programs for highway construction and repair.

VI. Defense Spending

The budget package requires reductions in defense spending during each of the next three years. However, the Pentagon will end up with a larger budget than Congress likely would have provided had no budget deal been negotiated.

The final legislation establishes annual defense spending ceilings for each of the next three fiscal years that closely mirror the ceilings in the September budget summit agreement. The ceilings require reductions below what defense spending would be if it kept pace with inflation of about $10 billion in FY 1991, $23 billion in FY 1992, and $35 billion in FY 1993. Yet these spending levels, said to reflect those favored by Georgia Senator Sam Nunn, the chair of the Senate Armed Services Committee, are well above the levels recommended by many defense experts. They also significantly exceed the levels in both the budget resolution and the defense authorization bill passed earlier in 1990 by the House of Representatives. For example, by FY 1993, the defense spending ceiling will be $14 billion higher than the level reflected in the House budget resolution and defense authorization bill.

The Pentagon also fared well in several other respects. The budget legislation alters the normal congressional budget process by providing that for the next three years, funds may not be transferred from defense to domestic spending. This could make the defense funding levels "floors" as well as "ceilings." Since further reductions in the defense budget during the next three years cannot fund domestic initiatives or reduce taxes -- and since no further reductions are needed during the next three years to reach the Gramm-Rudman-Hollings deficit targets (see Chapter II) -- it may be difficult to persuade Congress to set defense spending levels below the ceilings. These levels are well above those Congress otherwise would have been likely to approve, especially if the Persian Gulf crisis is resolved in the near future.

Table VI
Defense Spending, FY 1991 - FY 1993

	FY 1991	FY 1992	FY 1993
		(in billions of dollars)	
Final Defense Budget	BA* $288.3 O* 297.0	BA $290.9 O 295.0	BA $291.1 O 292.0
House budget resolution and House defense authorization bill	BA 283.0 O 295.5	BA 280.5 O 287.5	BA 275.4 O 277.8
Final defense budget compared to budget resolution and defense authorization bill	BA +5.3 O +1.5	BA +10.4 O +7.5	+15.7 +14.2

*BA refers to budget authority, or appropriations levels. O refers to outlays, or actual amounts spent during the fiscal year.

Furthermore, the budget package specifies that the incremental costs of Operation Desert Shield, the U.S. operation in the Persian Gulf, are outside of -- and in addition to -- the new defense spending ceilings. A number of defense experts believe this could enable the Pentagon to use creative accounting to portray some routine costs it would incur anyway as costs connected to Desert Shield. The defense spending ceilings thus appear a bit porous.

The impact of the budget ceilings is already being keenly felt. On October 9, the House Appropriations Committee added $5.3 billion to the FY 1991 defense appropriations bill. The Committee acted soon after Congress set the FY 1991 defense appropriations ceiling at the budget summit level. This was $5.3 billion above what the Appropriations Committee had earlier planned to provide for defense this year. Several weeks later, the FY 1991 defense appropriation bill was enacted into law, with the $5.3 billion included in it.

Experts Have Suggested Deeper Cuts

The defense ceilings set by the final budget are substantially higher than those recommended earlier this year by a Defense Budget Task Force composed of defense experts and former Pentagon, CIA, and other officials from both Republican and Democratic administrations. The Defense Budget Task Force is chaired by Lawrence Korb, a former assistant secretary of defense under President Reagan and includes such individuals as: William Colby, former director of the CIA; Paul Warnke, former director of the Arms Control and Disarmament Agency; and Rear Admiral Stanley Fine, retired former budget director of the Navy. The task force recommended defense appropriations levels that, by FY 1993, would be $23 billion lower than those reflected in the new budget law.*

The defense ceilings in the final budget package also significantly exceed those recommended by noted defense expert William Kaufmann. Now at the Brookings Institution, Kaufmann advised various Democratic and Republican administrations over several decades on the Soviet threat and U.S. military needs.

	FY 1991	FY 1992	FY 1993
	(in billions of dollars)		
New Defense Ceilings	BA 289.1	BA 291.6	BA 298.7
	O 297.0	O 295.0	O 292.0
Defense Budget Task Force	BA 293.1	BA 284.4	BA 275.3
	O NA	O NA	O NA
Kaufmann	BA 284.3	BA 273.6	BA 270.3
	O 290.4	O 289.3	O 279.6

* These recommendations are found in *Restructuring the U.S. Military: Defense Needs in the 21st Century*. The Defense Budget Task Force was staffed by the Defense Budget Project and the Committee for National Security.

Prospects for a Peace Dividend

Separate spending ceilings for defense and domestic programs essentially precludes a peace dividend from materializing for at least three years. To shift funds from defense to domestic programs would require new legislation overturning several key provisions of the new budget law. President Bush would

be virtually certain to veto such legislation, and it is doubtful two-thirds of both the House and Senate would vote to override his veto.

In FY 1994, the separate caps for defense, foreign affairs, and domestic non-entitlement programs are eliminated. Instead, one spending ceiling for all non-entitlement programs is set, with a comparable ceiling established for FY 1995.

This means that FY 1994 is probably the next opportunity to shift funds from defense to domestic spending and to realize a substantial peace dividend. Yet to realize a significant peace dividend in FY 1994, it will probably be necessary to set defense spending for FY 1992 and FY 1993 below the ceilings in the new budget law. If defense spending for those years is set at the maximum amount permitted under the ceilings, the Pentagon is free to move forward with its next generation of weapons systems such as the B-2 (Stealth) bomber. It then will be difficult to achieve significant further defense savings in FY 1994 for two reasons: 1) the costs of these weapons systems will grow sharply in future years, when the weapons move into full production; and 2) once major weapons systems move into production, it is hard to obtain enough votes in Congress to cancel them, since by then, there are probably weapons contracts and sub-contracts in many states and Congressional districts across the country.

That the defense spending ceilings in the new budget can protect the Pentagon's "wish list" of new weapons systems is illustrated by the events of the past six weeks. With the threat of military conflict with the Soviet Union sharply diminished, the House of Representatives passed a defense bill earlier this year cancelling several costly new weapons systems, such as the B-2 bomber. With the more generous defense funding levels provided under the budget agreement, however, funding for these weapons was restored. Despite the end of the Cold War, not a single major weapons system was cancelled this year.

VII. Changes in Budget Procedures

The budget legislation makes a number of important changes in the Gramm-Rudman-Hollings law. The law is extended though FY 1995, with the Social Security trust fund surplus excluded from the deficit calculations. In addition, new deficit targets are established for each of the next five years.

The new legislation also includes procedures requiring adjustments in the deficit targets during the next two years if economic or demographic factors -- or other factors beyond the control of policymakers -- affect the deficit. This provision virtually guarantees there can be no across-the-board cuts under the Gramm-Rudman-Hollings law during fiscal years 1991, 1992, or 1993.

The new budget legislation also includes a series of rigid measures to ensure that various aspects of the budget deal are complied with faithfully. These include the procedures that prevent funds from being shifted from defense to domestic non-entitlement programs during the next three years. The legislation also contains procedures requiring that any increases in entitlement programs or reductions in taxes be "paid for" through offsetting changes in other tax or entitlement provisions.

Changes in the Gramm-Rudman-Hollings Law

New GRH deficit targets are established for each of the next five years. The new targets for FY 1991 and FY 1992 are extremely high -- over $300 billion in each year -- both because of the continuing high costs of the savings and loan bailout and because the Social Security surplus, which substantially reduces the deficit, has been removed from the deficit calculations.

Table VII
Gramm-Rudman-Hollings
Deficit Reduction Targets

Fiscal Year	Deficit Target (in billions)
1991	$327
1992	317
1993	236
1994	102
1995	83

In another departure from past GRH procedures, these deficit targets will not be fixed targets that remain unchanged if the economy performs better or worse than expected. Instead, the GRH targets for fiscal years 1992 through FY 1995 will be revised at least twice to reflect economic, demographic, and other non-legislative changes that affect the deficit. These revisions are to be made by the President when he submits his budget for fiscal year 1992 (this will occur in February 1991) and when he submits his fiscal year 1993 budget the following year. The new law also permits (but does not require) the President to make similar adjustments in the deficit targets when he submits his budgets for fiscal years 1994 and 1995.

In a related change, the new law stipulates that the economic assumptions used in the deficit calculations for the coming fiscal year must be established in February, when the President's budget is issued, and cannot subsequently be changed. This is designed to prevent the Office of Management and Budget from using optimistic economic assumptions in preparing the President's budget early in the year and then revising the assumptions when Congress must make its budget decisions.

The effect of these changes is to ensure that during fiscal years 1991 through 1993, automatic across-the-board spending cuts can *not* be triggered as a result of overly optimistic economic assumptions or other factors beyond the control of policymakers. If the terms of the budget package (and the spending ceilings it establishes) are complied with faithfully, there will be no GRH sequester during the next three years. There could, however, be sequesters in FY 1994 and FY 1995 if the President elects *not* to adjust the deficit targets when presenting his budget proposals for those fiscal years.

Restraints on Spending

The new law also includes a series of modifications in the budget process designed to ensure that the deficit reduction envisioned in the budget package -- nearly $500 billion over five years -- is achieved. Prominent among these changes are new provisions intended to ensure that spending is constrained.

As noted in Chapter V, the agreement divides non-entitlement programs into three categories -- defense, international affairs, and domestic non-entitlement programs -- and establishes binding ceilings for each category for each of the next three years. To ensure that these ceilings are not breached, the budget law creates a new automatic budget-cutting mechanism known as a "categorical sequester."

The categorical sequester works in the following manner. If legislation were enacted breaching either the appropriations ceiling or the spending ceiling for a particular category of non-entitlement programs, an automatic across-the-board cut would be applied to the programs in that category. The sequester would be set at the level required to bring the category back within its ceiling. Thus, if the ceiling for domestic non-entitlement programs were breached, there would be an across-the-board cut just among domestic non-entitlement programs.

The budget agreement also creates a categorical sequester for entitlement programs. Any entitlement program increase must be offset, during the Congressional budget cycle, by a reduction in another entitlement or by a revenue increase. Suppose, however, Congress still passes -- and the President signs -- legislation increasing an entitlement without passing other legislation fully offsetting the new costs. If that occurs, a categorical sequester is triggered among all entitlements except those, such as Social Security and most means-tested entitlements, that are exempt from sequestration under the Gramm-Rudman-Hollings law.[6]

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[6] The September budget summit agreement stipulated that any increase in an entitlement program must be offset *in the same piece of legislation* by another entitlement cut or a tax increase. Such a requirement would have made it difficult to increase any entitlement not under the jurisdiction of the House Ways and Means Committee or the Senate Finance Committee because these committees have jurisdiction over taxes. The final budget package dropped the requirement that the offsetting savings be contained in the same legislation. Instead, the Office of Management and Budget, within 15 days of the end of each session of Congress, will tally up all entitlement expansions enacted in the past year and determine whether the new spending was fully offset by entitlement cuts or tax increases. If OMB determined that new entitlement initiatives were not fully paid for, a categorical sequester would be triggered among entitlement programs that are not exempt under the Gramm-Rudman-Hollings law.

These categorical sequesters would *not* apply, however, if a tax cut was enacted that was not fully offset by a tax increase or a reduction in entitlement spending. If that occurred, taxes would not automatically be raised. Instead, the congressional committees responsible for the tax increase legislation would be directed to pass a new piece of legislation achieving offsetting savings. The committees could achieve these savings either by raising revenues or by cutting entitlements. If the committees did not comply and offsetting savings were not produced, then all non-exempt entitlement programs would be subject to an across-the-board sequester.

Increased Power for OMB

One key question in this area centers on who determines whether an entitlement increase or a tax cut is fully "paid for" or if one of the spending ceilings on non-entitlement spending has been breached. Under the new budget procedures, the Office of Management and Budget makes this decision unilaterally.

This aspect of the agreement is cause for concern. OMB has a long history of claiming that entitlement increases would cost more than the Congressional Budget Office forecasts and that tax cuts would lose less revenue than CBO and the Joint Committee on Taxation believe. For example, OMB has claimed for the past year and a half that cutting the capital gains tax rate would *increase* federal tax collections over the next five years, a conclusion that is disputed by most experts in the field and that seems politically motivated.

This aspect of the budget legislation thus gives OMB new leverage to block improvements in entitlement programs by providing high estimates of their costs. It also may give OMB leverage to push new tax breaks the White House favors by underestimating the likely revenue losses that would result.

OMB already had unilateral responsibility for determining when across-the-board reductions are required under the Gramm-Rudman-Hollings law. However, OMB could use this new authority in a more selective manner. Until now, if OMB determined that sequestration was required under the Gramm-Rudman-Hollings law, the across-the-board cuts fell on both defense and domestic programs. But under the new procedures, OMB will have the power to trigger automatic reductions that affect domestic non-entitlement programs only or that impact only on non-exempt entitlements. Even here, however, OMB would not be able to fashion automatic reductions that bypass all programs the Administration favors. For example, an automatic reduction targeted on domestic non-entitlement programs would affect such areas as law enforcement, drug interdiction, and space exploration.

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